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Managing Director & Principal*

August 5, 2008

Ms. Anne Stausboll
Interim Chief Investment Officer
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re: Annual Performance Review

Dear Anne,

Per your request, our thoughts regarding CalPERS' performance for the fiscal year ended June 30, 2008, are contained in this letter.

Market Review

Fiscal Year 2008 was characterized by a number of macro-economic shocks to the consumer, housing, and corporate sectors of the market, resulting in a poor year overall for Public Equity investments but an above-average year for the Fixed Income market. Private Equity in general performed well above expectations while Real Estate as an asset class returned moderately better than CalPERS' long-term expectation.¹

Total Fund Performance

The net result of this year's market movements was a decline in CalPERS' Total Fund benchmark of 1.6% for the fiscal year. Unfortunately, CalPERS' actual performance was slightly worse than the benchmark, returning -2.6% for the fiscal year. As you will see below, there were many causes of this underperformance and it was not restricted to a single asset class.

The good news is that Staff was able to add some value through asset allocation. Over the last three quarters, Staff has been purposely keeping the allocation to Equities moderately below the asset class target (this is allowed under delegated authority), resulting in a slight mitigation of the impact of the poor equity markets.

In addition, although the asset class is too new to have an entire year's performance to discuss, the new Inflation Linked Asset Class helped Total Fund Returns due to the

¹ Private Equity and Real Estate performance, both for the industry and for CalPERS' investments, is for the year through March 31, 2008, and therefore does not include the second calendar quarter of 2008.

strongly positive results of the commodities portfolio, which returned 29% in the second quarter alone.

Global Equities

Global Equities was the worst performing asset class for the year, with a total return of -11.4% versus the policy benchmark of -10.2%. A little more than half of this underperformance can be explained simply by the passive currency hedging program, which mitigated the benefits to CalPERS of the positive impact the falling dollar has on foreign investments. Excluding the impact of the currency hedge, Global Equities returned -10.7% for the year, a total underperformance of only 0.5%.

The causes of this underperformance, though, were many.

The Corporate Governance program, which has a significant small-cap bias and is very long-term in nature, returned -20.8% for the year, 7% below its benchmark. Staff will present an agenda item at the August meeting to discuss this performance and their annual plan for the coming year. Generally speaking, the de facto value-bias and small cap-bias built into any corporate governance program acted as a headwind for the program in the current large cap and growth-favoring market cycle.

The Risk Managed Absolute Return Strategies program failed to live up to the “absolute return” portion of its name, and generated a -1.5% return for the year, 12% below its benchmark. Wilshire is currently in the process of conducting its annual review of the entire program, including the two outside advisors, and will present the results of this review at the September Investment Committee meeting. CalPERS’ portfolio is not the only absolute return focused vehicle that faced a difficult year. For example, the CSFB Tremont Multi-Strategy Index, a proxy for an absolute return program, lost 4.55% over the fiscal year. Two key factors affected returns for these types of strategies. First, many of these strategies are built for stable or declining credit spread environments. During the fiscal year, credit spreads widened substantially causing lackluster performance. For example, the CSFB Tremont Convertible Arbitrage Index fell by 14.3% during the fiscal year. Secondly, hedged equity strategies, such as equity long/short and equity market neutral retain some market beta. In an environment where the equity markets fall precipitously, this residual beta acts as a drag on these strategies. For example, the CSFB Tremont Long/Short Equity Index fell 5.1% during the fiscal year. Since credit strategies and relative value strategies are a key component of many absolute return programs, these two effects were pervasive.

External managers in general underperformed by approximately 1%, with mainstream managers losing 0.5% value-added, enhanced managers losing 2.2%, and 130/30 managers losing 1.6%. Higher-quality investments were the most liquid investments in which hedge funds reduced leverage last fall, hurting CalPERS’ managers

disproportionately. Staff is in the midst of re-evaluating and restructuring this program, and the manager line-up is changing significantly.

The \$1BN Internal Domestic Fundamental portfolio underperformed its target by 7.6%, largely due to the “value bias” contained in this portfolio. The 12 months ended 6/30/08 were a strong period for growth investing versus value investing, with some segments (small cap in particular) of the US equity market returning 14% to 18% higher for growth than for value. In addition, the Fundamental Index, upon which this strategy is based, was reconstituted in March of this year. Given that one of the weighting components is book value, the reconstitution effectively raised the weight of Financials in the index meaningfully (many of the writedowns within the Financial industry were still ongoing at that point). Financials faced a very difficult quarter during the second calendar quarter of 2008, losing more than 15%. So, the increased weight (due to the ordinary rebalancing procedure of the index) occurred at a particularly unfortunate time.

Similarly, the Domestic Enhanced Index Strategy underperformed by 0.90% for the year, both as a result of a slight value bias and tendency by most quantitative managers to underperform for most of this year due to “contagion” effects from delevering by hedge funds last fall. It should be noted that this portfolio rebounded by 1.6% in the second quarter as these effects waned.

Not all was bad news for the year in Domestic Equities, and there were some highlights worth discussing. The \$44 billion internal index fund, the majority of the US assets, had another solid year and generated 0.20% of positive tracking above its benchmark. In addition, the Dynamic Completion Fund and the Internal Microcap Index also yielded value-added of 0.2% and 4.1%, respectively. Finally, the Domestic Environmental Program added 3.3% of value above its benchmark, albeit on a small asset base.

For the Non-US Equity investments, the \$31BN internal index fund was again the bright spot, returning in-line with its benchmark for the year.

As with the US portion of the equity assets, active external managers underperformed by 1.6% for the year for many of the same reasons and the Fundamental and Structured Developed and Emerging portfolios were hurt by the same value bias as their US counterparts.

Finally, the Environmental Program, which added-value in the US, underperformed by 1.5% in Non-US Equities.

Fixed Income

In total, Fixed Income returned 7.7% for the year, 1.1% below its benchmark return.

The externally managed non-US portion of the portfolio returned 17.6%, 0.1% better than its benchmark. While the slight value-added resulted from manager skill, the overall 17% return was largely due to the dramatic drop in the value of the dollar over the past year. This portfolio is not hedged to the dollar, and will see significant volatility during times of rapid exchange rate change.

The internally managed domestic Fixed Income portfolio underperformed by 0.40% for the year, mainly due to the greater weight placed on credit and mortgage bonds than is contained in the benchmark. Staff believes that over long periods of time, the greater yield on corporate and mortgage bonds versus government securities more than compensates an investor for the increased default risk. This view is largely supported by both Wilshire and academic research. However, over the short term, when there are sharp movements in excess yields (“credit spreads”), this strategy can underperform. Obviously, over the past year, the fixed income market has faced a significant “credit crunch” which has impacted corporate and mortgage bonds negatively, generating positive results to those investors who favor safer, lower yielding treasury portfolios. We believe that CalPERS’ spread-oriented approach will generate superior results over the long term (0.40% annual value added for the last five years) and that changing strategies now to a less risky position will miss the eventual rebound in the market.

Although small, the Opportunistic Program also had a negative effect on performance, returning -13% for the year. Although internally-managed high yield bonds actually outperformed the asset class as a whole, external managers saw their performance return -8.3% as the high yield market as a whole was impacted by the same effects as the credit sector, but magnified due to the greater default risk.

Real Estate

Over the past year, Real Estate has really been a “Tale of Two Asset Types.” On the whole, the asset class returned 5.9% for the year² versus 13.6% for the NCREIF index.

However, Core properties had another excellent year, returning over 19%. Despite the much-publicized woes of the housing portion of the Real Estate industry, commercial properties of all types continue to perform well. First, commercial office space has not been significantly impacted by the slowing economy. Second, retail real estate (malls) has seen foot traffic diminish as consumers pull back on spending, but shuttering of stores or reduced rents tend to trail consumer spending changes. Third, the shift of many homeowners back to rental apartments has had a strong impact on the for-lease section of the real estate market. As a result, in total, Core properties returned 5.8% better than NCREIF for the year.

² For the 12 months ended March 31, 2008.

The problem was in the Special Real Estate section of the portfolio (opportunistic real estate), which returned -6.9% for the year. New property development in the industry has slowed, financing rates (when financing is even available) have increased, and end consumer demand for new property has fallen. As a result, while we believe that value-added or opportunist real estate are excellent investments for the long term, since they provide an opportunity to create new sources of value and can take advantage of information inefficiencies, in the short term periods of dislocation can occur. In addition, this has been a very difficult year for REITs, which are included in the Opportunistic Portfolio and which had a double-digit negative return for the year.

AIM

The AIM portfolio performed very well for the year, with a total return of 19.6%.³ Despite the slowdown in the equity markets as a whole, investor demand for Venture Capital investments has continued unabated, and the long-term nature of these “new company incubating” investments will not be affected by short term market movements. Increases in interest rates and a lack of availability of financing will decrease the potential for Leveraged Buyout investments going forward, but will not impact investments made within the last few years which are now bearing fruit. As a result, we expect the AIM portfolio’s performance to moderate over the next few years toward CalPERS’ long-term return expectation, but we do not expect this portfolio to fall into negative territory for any longer period of time. To some extent, this effect may be ameliorated by the vast and growing opportunity set in the distressed debt sector of the private markets.

Cash Equitization

Although we do not frequently comment much on the Cash Equitization portion of CalPERS’ portfolio, we believe that it bears special mention here. To avoid the long-term impacts of “cash drag” (i.e., earning 3% on cash investments instead of 6% on bonds or 8% on stocks), CalPERS purchases highly liquid market index derivatives to obtain full exposure to the Equity and Fixed Income markets. Over time, we expect that this approach should yield results superior to simply holding cash in a short term account. However, over periods of significant negative market movements, this portfolio will underperform the cash equivalent return. For the last year, this portfolio has been mainly in Equity market instruments and has returned -9.3%, 13.5% worse than a cash investment. At approximately 1% of total assets, this had a 0.14% negative impact on total fund performance, or approximately 1/6 of the total underperformance for the year.

Summary

³ For the 12 months ended March 31, 2008.

In short, poor performance and underperformance for the year were not limited to any single investment or asset class. The overall impacts of the housing market and credit crunch impacted the US and Non-US Equity portfolios, Corporate and Mortgage Fixed Income portfolios, and Non-Core Real Estate portfolios. We believe that CalPERS is broadly diversified, though, to mitigate any continued decline in any of these investments, and we also believe that CalPERS is well-positioned across a wide variety of asset classes for the eventual economic and market rebounds.

If you have any additional questions, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Schlachter", with a long horizontal flourish extending to the right.

Michael C. Schlachter, CFA